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TAGS: ECON EFIN PREL CH HK
SUBJECT: CHINA'S ECONOMIC POLICIES THE FOCUS OF FINANCIAL
ATTACHE LOEVINGER'S HONG KONG MEETINGS

Classified By: E/P Chief Simon Schuchat. Reason: 1.4 (b,d)

SUMMARY

¶1. (C) Hong Kong-based investment bank analysts and economists generally welcome China's recent economic tightening measures, and some believe that recent and significant appreciation of Asian currencies may lead to quicker upward movements in the value of the renminbi (RMB). They used the occasion of meetings held May 2-5 with Embassy Beijing's newly-arrived Financial Attache David Loevinger to suggest that U.S. efforts to get China to move on currency appreciation and capital account liberalization are most effective when presented via private diplomacy and in the context of the mainland's own long-term economic interests. Loevinger also discussed the apparent near-intractability of China's high rate of precautionary savings and heard several analyses of how uncertainty about future needs for education, health care, housing, and retirement drives consumers to minimize their day-to-day spending. END SUMMARY

VISIT DETAILS AND MEETINGS

¶2. (U) Embassy Beijing's newly-arrived U.S. Treasury Financial Attache David Loevinger held meetings in Hong Kong May 2-5 with investment bank analysts, academics, economists, and Hong Kong Government officials, including:

- -- William Ryback, Deputy Chief Executive, Hong Kong Monetary Authority
- -- Guonan Ma, Senior Economist Bank of International Settlements
- -- Jonathan Anderson, Managing Director, UBS
- -- Hong Liang, Executive Director, Asia-Pacific Research, Goldman Sachs
- -- Jun Ma, Managing Director, Deutsche Bank
- -- Grace Ng, Managing Director, JP Morgan
- -- Simon Ogus, Chairman, Dismal Science Group (DSG)
- -- Hongbin Qu, Senior China Economist HSBC
- -- Jim Walker, China Economist, CLSA
- -- Geng Xiao, Associate Professor of Finance, Hong Kong University
- -- Andy Xie, Managing Director, Morgan Stanley

BROADER MEANING IN RECENT INTEREST RATE HIKE

¶3. (SBU) China raised lending interest rates by 0.27 percent to 5.85 percent on April 27. Our interlocutors downplayed the economic significance of the hike itself but saw broad significance in the move. UBS's Anderson believes the increase signals to banks that the People's Bank of China (PBC) is getting serious about reining in recent credit growth, a danger in particular for the property and construction sectors, and may take administrative action to follow it up. That said, the small magnitude implies that the PBC is not concerned overall with economic overheating.

¶4. (C) CLSA's Walker disagrees with that interpretation. He observed that the increase has come notably early in the current cycle of discussion about overheating and suspects that monetary authorities are acting quickly because they expect rising commodity prices and wage rates to be reflected shortly in inflation trends. Walker, referring to recent conversations with mainland think tank economists, suggested that PRC economic policy officials are likely heeding a lesson of history: once inflation is embedded in China's economy, it is hard to stop without a shock to the system. In line with Walker's views, HKMA's Ryback praised the PBC for its early intervention, commenting that it is better to brake now than later. He noted that Hong Kong's benchmark stock index for China listings had rebounded quickly after the shock of the news; this suggests a broad acceptance that mainland officials are acting appropriately to preserve better prospects for the long run.

TRICKY CURRENCY POLICY ENVIRONMENT

¶5. (C) The China watchers listed changing conditions that support a more rapid rise in the RMB, but they made clear that appreciation has been held in check in part because of conservative voices in the Chinese government (e.g., NDRC, Commerce) and sensitivities about economic relations with the U.S. They observed that the undervalued RMB is drawing in excess foreign currency, complicating needed efforts to restrain credit growth. Goldman's Liang said that appreciation of other Asian currencies this year increases the likelihood of the RMB rising more quickly. (Note: As of May 8, the Korean Won was up nearly 9 percent, the Singapore dollar 6 percent, the Japanese yen 5 percent. End Note.) This trend not only reduces the trade-weighted value of the RMB but also creates the unwelcome prospect of trade tensions between China and Asian trade partners -- and besides, China is by nature a "follower" in taking action on regional financial challenges. JP Morgan's Ng suggested that the RMB might have moved more on the occasion of Hu's visit to Washington had the Chinese side not concluded that U.S. late-game emphasis on IPR issues implied that a currency deliverable was not necessary. Like Liang, she focused on the trade-weighted value decline of the RMB and concluded that the down-trend of the USD among other currencies offers China a very good opportunity for letting significant appreciation go forward.

¶6. (C) Liang and Ng separately emphasized the importance that Japan's experience with currency appreciation plays in the minds of NDRC economists and others in the economic bureaucracies. While there is a debate to be had about just what caused Japan's lengthy stagnation in the 1990s, Chinese policy makers are clearly wary of how the 1985 Plaza Accord, which led to yen appreciation, is often cited in the chain of events that made it difficult for Japan to deal with a recession some years later. Ng said that China sees itself as a much poorer country than Japan was in 1985 and therefore less capable of dealing with any resulting shocks from a RMB rise.

¶7. (C) HKU's Geng emphasized the role that anxieties about

inflation and deflation play for China in crafting RMB policy approaches. He lamented that China does not have a higher rate of inflation -- perhaps 5 percent would be desirable -- as this would be typical of an economy experiencing such high levels of growth and transition. Since productivity is rising rapidly, it is only natural that the prices of non-tradable goods would rise relative to tradables, i.e., changes in relative prices should be expected. The public, however, has strong negative associations with inflation based on experiences in the 1970's and 1990's. Meanwhile, overcapacity in sectors like steel and cement leaves policy makers fearful of igniting deflation through a currency hike. Were the public accepting of moderate inflation and were this to already exist in the economy, then the pondered effect of a rising RMB would merely be a decrease in the inflation rate rather than the prospect of slipping into deflation.

SUGGESTIONS FOR U.S. DIPLOMACY

¶8. (C) We received numerous comments that the U.S. messages to China on currency policy and financial liberalization should be delivered privately and should be packaged with emphasis on why taking various steps is in the interest of the mainland itself. "Bullying" that is done in the context of U.S. domestic political debates is counter-productive, in the view of several of the China watchers we met with. Morgan Stanley's Andy Xie said the U.S. will continue to be challenged by a historical Chinese attitude that dangers ahead are best approached by "muddling through." In his view, the U.S. should propose packages of measures that taken together would not amount to "shock therapy" for a society that is already very tense amidst economic transition. Goldman's Liang said the U.S. needs to bolster its own credibility by showing that it will reduce its fiscal deficit. In her view, China's leadership sees the unwinding of global imbalances as a question of burden sharing. China's approach with the U.S. is actually an act of bargaining over who will feel what economic pain. JP Morgan's Ng emphasized the "face" aspects of public criticism, cautioning that the most likely factor in whether RMB appreciation is slowed from what it would be otherwise is

America's public posture on the issue. BIS's Ma said the U.S. should note to China how currency liberalization would lift China's capacity to manage economic shocks and crises.

PRECAUTIONARY SAVINGS

¶9. (SBU) There was little optimism on the issue of precautionary savings, i.e., the tendency of Chinese consumers to save a high proportion of income in response to concerns about future requirements with regard to education, health care, housing, and retirement. Morgan Stanley's Xie called on the PRC to boost consumer spending power with bond issuances aimed at rural residents and through distribution of proceeds from the sale of state assets. A major challenge is the erratic nature of future costs, e.g., costs for medical treatment are unclear or inflated by corruption while education fees are erratic in their composition and rising quickly. HSBC's Qu noted that much of what is saved is for specific goals (e.g., housing), so efforts to raise returns on savings should help -- such as recently announced provisions to allow for limited individual investment in assets abroad. BIS's Ma suggested that the savings issue is aggravated by the one-child policy -- working parents are concerned at the prospect of having only one child to assist them in retirement -- a factor that is not going to go away any time soon.
Cunningham